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No. 415

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In the Supreme Court of the United States

OCTOBER TERM, 1961

HAROLD M. and SECRIE EKBERG, *Petitioners*

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

ARCHIBALD COX,
Solicitor General,

JOHN B. JONES, JR.,
Acting
Assistant Attorney General,

MELVA M. GRANEY,
KENNETH E. LEVIN,
Attorneys,
Department of Justice,
Washington 25, D. C.

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OPINIONS BELOW

The District Court wrote no opinion. The opinion of the Court of Appeals (Pet. A1-A24) is reported at 291 F. 2d 913.

JURISDICTION

The judgment of the Court of Appeals was entered on June 21, 1961. (Pet. A25). The petition for a writ of certiorari was filed on September 18, 1961. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether petitioner, having elected to use the unit-livestock-price method of valuing his cattle inventory, was properly required by the Treasury Regulations to apply that method of valuation to his raised breeding herd also, and whether his attempt to reduce the basis of the breeding herd to zero by means of an annual "depreciation" deduction amounted to a change of accounting method prohibited by Section 446(e) of the 1954 Code without the Commissioner's consent.

STATUTE AND REGULATIONS INVOLVED

Section 446(e) of the Internal Revenue Code of 1954, and Sections 1.61-4, 1.446-1, and 1.471-6 of Treasury Regulations on Income Tax (1954 Code), appear in the Appendix, *infra*, pp. 10-14.

STATEMENT

The petitioner[1] is engaged in the business of raising high quality, pure-bred, Aberdeen-Angus cattle. For that purpose he constantly maintains a breeding herd of cattle to which he adds only heifers or cows which he has raised. All heifer calves born in the herd are held for breeding purposes until otherwise designated. (R. 20.)

The petitioner uses the "unit-livestock-price method" of valuing his inventories, which include livestock raised. He has always assigned a unit price of $70 per head to his raised livestock, and all cattle have been included in inventory at that unit value in the year of birth. (R. 20.)

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[1] Harold M. Ekberg will be referred to as the sole petitioner. His wife is a party only because they filed joint returns.

In 1954, the petitioner began to remove raised yearling heifers from inventory to a depreciation schedule. In 1954 he removed 170 yearling heifers; in 1955 he removed 135 yearling heifers; and in 1956 he removed 95 yearling heifers. The petitioner claimed an annual depreciation deduction for each animal so removed, based upon recovering the $70 unit valuation over its estimated useful life of six years remaining at the time it was placed on the depreciation schedule. No purchased livestock was removed by the petitioner from inventory to the depreciation schedule during the taxable years 1954, 1955, and 1956. The depreciation deductions claimed for cattle so transferred were disallowed by the Commissioner, as were certain other depreciation deductions not involved here. (R. 20-21.)

The District Court found as a fact that the petitioner changed the accrual method of reporting his taxable income without the consent of the Commissioner, but only to the extent of transferring breeding livestock which he had carried in inventory under the "unit-livestock-price method" to the depreciation schedule, and that the petitioner in the process made no changes in the inventory valuations he had given to such livestock. The court held, in its conclusions of law, that the petitioner had the right to transfer these cattle to the depreciation schedule and depreciate their value to zero over the period of their useful life; that such transfer did not amount to a change in accounting method, so that the Commissioner's consent was not required; that the regulation relied on by the Government was not applicable to the depreciation method employed by the petitioner; and that the petitioner by use of such depreciation method achieved capital gains tax treatment, approximating though not equalling

that accorded owners of breeding stock reporting income on a cash basis method of accounting. (R. 23-25.)

The Court of Appeals reversed the judgment of the District Court, holding that the petitioner, having chosen to use the unit-livestock-price method of valuing his inventory, could reasonably be required by the Treasury Regulations to apply that method of valuation to all cattle raised, including his breeding herd, and that his attempt to reduce the basis of his breeding herd to zero by removing it from inventory and taking annual "depreciation" deductions amounted to a change of accounting method prohibited without the consent of the Commissioner. (Pet. A1-A24.)

ARGUMENT

The decision of the Court of Appeals is correct, and is in harmony with the position of the Tax Court and the Court of Appeals for the Ninth Circuit. See *Little* v. *Commissioner,* 34 T.C. 156, affirmed July 7, 1961 (8 A.F.T.R. 2d 5124); *Frost* v. *Commissioner,* 28 T.C. 1118. The decision of the Court of Appeals for the Fifth Circuit in *Scofield* v. *Lewis,* 251 F. 2d 128, with which the petitioner asserts a conflict, is not only distinguishable, but has been definitely limited, if not emasculated, by a latter decision of the same court (see *Carter* v. *Commissioner,* 257 F. 2d 595). Further review of the issue by this Court is unnecessary.

The essential question is whether the petitioner's attempt to remove his breeding herd from inventory and reduce its basis to zero without the consent of the Commissioner is a change of accounting method prohibited by Section 446(e) of the 1954 Code, Appendix, *infra,* p. 10, and the Treasury Regulations. The

petitioner's position, based on *Scofield* v. *Lewis, supra*, is that the breeding herd had been included in inventory in the first place only pursuant to an invalid Treasury Regulation—Section 29.22(c)-6 of Treasury Regulations 111 (1939 Code), later Section 1.471-6(f) of Treasury Regulations on Income Tax (1954 Code), Appendix, *infra*, p. 14—which ruled that a taxpayer who elects to use the unit-livestock-price method of valuing inventory must apply it to all livestock raised, whether for sale or for draft, breeding, or dairy purposes. He argues that the removal of his breeding herd from inventory is merely the correction of an error caused by his prior adherence to this regulation now asserted to be invalid. But Section 1.446-1(e)(2)(i) of the Treasury Regulations on Income Tax (1954 Code), Appendix, *infra*, pp. 11-12, states—

> A change in the method of accounting includes a change in the over-all method of accounting for gross income or deductions, or a change in the treatment of a material item. Consent must be secured whether or not a taxpayer regards the method from which he desires to change to be proper.

The Court of Appeals held that the petitioner had chosen the unit-livestock-price method of valuing his inventory, and thereby subjected his breeding herd to valuation by that method, voluntarily and with awareness or the means of awareness of the consequences and alternatives; that the regulation complained of is not invalid; that the breeding herd was a material item whose removal from inventory amounted to a change of accounting method; and that this could not be done without the Commissioner's consent.

The Commissioner's duty is to require that the taxpayer use a method of accounting which clearly reflects income. *Brown* v. *Helvering*, 291 U.S. 193, 203. In executing that duty, the Commissioner has allowed to the farmer perhaps the widest latitude of any taxpayer in choosing his method of accounting. He may use an inventory method or cash receipts method. Treasury Regulations on Income Tax (1954 Code), Section 1.471-6(a), Appendix, *infra*, p. 12. He may treat his breeding herd as a capital asset subject to depreciation or include it in inventory. Treasury Regulations on Income Tax (1954 Code), Section 1.61-4(b), Appendix, *infra*, p. 10. If he uses an inventory method, he has the option of two methods of valuation other than the ordinary ones, and these have been authorized with the specific objective of easing the farmer's accounting problems. Treasury Regulations on Income Tax (1954 Code), Section 1.471-6(c), (d), and (e), Appendix, *infra*, pp. 12-13. Section 29.22(c)-6 of Treasury Regulations 111, providing that a farmer who chose to use the unit-livestock-price method of valuing inventories must apply it to all livestock raised, was repromulgated in 1953 as Section 39.22(c)-6(f) of Treasury Regulations 118 (1939 Code), and was in effect when Congress adopted the Internal Revenue Code of 1954 without changing it. It was repromulgated under the 1954 Code as Section 1.471-6(f) of the Treasury Regulations on Income Tax. Thus, the section acquired the added weight of congressional approval. *Brewster* v. *Gage*, 280 U.S. 327, 337; *Helvering* v. *Winmill*, 305 U.S. 79, 83; *Boehm* v. *Commissioner*, 326 U.S. 287, 291-292.

The Court of Appeals here, and the Tax Court and the Court of Appeals in *Little* v. *Commissioner, supra,* have cogently stated why the Treasury Regulations could properly provide that a cattle raiser who chooses to use the unit-livestock-price method of valuing inventory must value all livestock raised by that method. Essentially the reason is that the right to use the unit-livestock-price method of valuing inventory is conferred by the Treasury Regulations—not by the Code—and provides definite advantages to the taxpayer who, if he chooses to use it, must accept its burdens as well. Cf. *Moline Properties* v. *Commissioner*, 319 U.S. 436, 439; *Higgins* v. *Smith*, 308 U.S. 473, 477. The Court of Appeals here pointed out that in declaring this section of the Regulations invalid in *Scofield* v. *Lewis, supra*, the Court of Appeals for the Fifth Circuit completely overlooked the aspects of the unit-livestock-price method which are advantageous to the taxpayer, and focused on the aspects which are disadvantageous.

In *Scofield* v. *Lewis*, the Fifth Circuit also emphasized its belief that the taxpayer there elected to use the unit-livestock-price method, and thereby subjected his breeding herd to valuation by the same method, before it was known that the gain upon the sale of a breeding herd could be treated as capital gain rather than ordinary income. It should be noted that the taxpayer in *Lewis* had carried his breeding herd in inventory since 1939. On the other hand, in the instant case, the taxpayer has been engaged in the business of raising Angus cattle only since 1947 (R. 27-28), and the Court of Appeals pointed out (Pet. A22) that, in 1944, the Internal Revenue Service issued I.T. 3666, 1944 Cum. Bull. 270, recognizing that capital

gains treatment was available upon the disposition of breeding cattle if all other necessary elements were satisfied. Therefore, the taxpayer here, unlike the taxpayer in the *Lewis* case, did have a meaningful option with respect to his accounting method when he went into business in 1947.

The instant case is further distinguishable from *Lewis* in that *Lewis* arose under the 1939 Code, which contained no statutory bar to a taxpayer's change of accounting method without the Commissioner's consent. The Fifth Circuit in *Lewis* did not say that the taxpayer's removal of his breeding herd from inventory was not a change of accounting method. It merely ignored the Treasury Regulations and judicial authorities which purported to bar a change of accounting method without the Commissioner's consent. The instant case arises under the 1954 Code which in Section 446(e) contains a specific *statutory* prohibition against a change of accounting method without the Commissioner's consent. The Court of Appeals here affirmatively held that the removal of a breeding herd from inventory constitutes a change of accounting method, and with this the Fifth Circuit clearly agreed in *Carter* v. *Commissioner,* 257 F. 2d 595, 600-601, a case which it decided subsequently to *Scofield* v. *Lewis, supra.* Removal of the taxpayer's breeding herd from inventory was therefore barred in the instant case by Section 446(e) of the 1954 Code.

It should also be noted that in *Carter,* the Fifth Circuit clearly implied second thoughts with respect to its decision in *Scofield* v. *Lewis,* by purporting simply to limit it to its own facts, and then relying on an earlier Tax Court decision which reached an opposite result

on similar facts—*Frost* v. *Commissioner*, 28 T.C. 1118. It is our belief that *Scofield* v. *Lewis* is not only distinguishable from the present case, but also of doubtful remaining vitality, even in the Fifth Circuit.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

ARCHIBALD COX,
Solicitor General,

JOHN B. JONES, JR.,
Acting
Assistant Attorney General,

MELVA M. GRANEY,
KENNETH E. LEVIN,
Attorneys.

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APPENDIX

Internal Revenue Code of 1954:

SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

* * * * *

(c) *Requirement Respecting Change of Accounting Method.*—Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary or his delegate.

(26 U.S.C. 1958 ed., Sec. 446.)

Treasury Regulations on Income Tax (1954 Code):

Sec. 1.61-4. *Gross Income of Farmers.*

* * * * *

(b) *Farmers using an accrual method of accounting.*—A farmer using an accrual method of accounting must use inventories to determine his gross income. * * *

* * * * *

All livestock raised or purchased for sale shall be added in the inventory at their proper valuation determined in accordance with the method authorized and adopted for the purpose. Livestock acquired for draft, breeding, or dairy purposes and not for sale may be included in the inventory (see subparagraphs (2), (6) and (7) of this paragraph) instead of being treated as capital assets subject to depreciation, provided such practice is followed consistently from year to year by the taxpayer. * * *

* * * * *

Sec. 1.446-1. *General Rule for Methods of Accounting.*—(a) *General rule.*—(1) Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. The term "method of accounting" includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item. Examples of such over-all methods are the cash receipts and disbursements method, an accrual method, combinations of such methods, and combinations of the foregoing with various methods provided for the accounting treatment of special items. These methods of accounting for special items include the accounting treatment prescribed for research and experimental expenditures, soil and water conservation expenditures, depreciation, net operating losses, etc. Except for deviations permitted or required by such special accounting treatment, taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. For requirement respecting the adoption or change of accounting method, see section 446(e) and paragraph (e) of this section.

* * * * *

(e) *Requirement respecting the adoption or change of accounting method.* * * *

(2) (i) Except as otherwise expressly provided in chapter 1 of the Code and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. A change in the method of accounting includes a change in the over-all meth-

od of accounting for gross income or deductions, or a change in the treatment of a material item. Consent must be secured whether or not a taxpayer regards the method from which he desires to change to be proper. Thus, a taxpayer may not compute his taxable income under a method of accounting different from that previously used by him unless such consent is secured.

(ii) Examples of changes requiring consent are: A change from the cash receipts and disbursements method to an accrual method, or vice versa; a change involving the method or basis used in the valuation of inventories (see sections 471 and 472 and the regulations thereunder); a change from the cash or accrual method to a long-term contract method, or vice versa (see § 1.451-3); a change involving the adoption, use, or discontinuance of any other specialized method of computing taxable income, such as the crop method; or a change in the treatment of any other items of income or expense, where material.

* * * * *

Sec. 1.471-6. *Inventories of Livestock Raisers and other farmers.*—(a) A farmer may make his return upon an inventory method instead of the cash receipts and disbursements method. It is optional with the taxpayer which of these methods of accounting is used but, having elected one method, the option so exercised will be binding upon the taxpayer for the year for which the option is exercised and for subsequent years unless another method is authorized by the Commissioner as provided in paragraph (e) of § 1.446-1.

* * * * *

(c) Because of the difficulty of ascertaining actual cost of livestock and other farm products,

farmers who render their returns upon an inventory method may value their inventories according to the "farm-price method", and farmers raising livestock may value their inventories of animals according to either the "farm-price method" or the "unit-livestock-price method".

(d) The "farm-price method" provides for the valuation of inventories at market price less direct cost of disposition. If this method of valuing inventories is used, it must be applied to the entire inventory except as to livestock inventoried, at the taxpayer's election, under the "unit-livestock-price method". If the use of the "farm-price method" of valuing inventories for any taxable year involves a change in method of valuing inventories from that employed in prior years, permission for such change shall first be secured from the Commissioner as provided in paragraph (e) of § 1.446-1.

(e) The "unit-livestock-price method" provides for the valuation of the different classes of animals in the inventory at a standard unit price for each animal within a class. A livestock raiser electing this method of valuing his animals must adopt a reasonable classification of the animals in his inventory with respect to the age and kind included so that the unit prices assigned to the several classes will reasonably account for the normal costs incurred in producing the animals within such classes. Thus, if a cattle raiser determines that it costs approximately $15 to produce a calf, and $7.50 each year to raise the calf to maturity, his classifications and unit prices would be as follows: Calves, $15; yearlings $22.50; 2-year-olds, $30; mature animals $37.50. The classification selected by the livestock raiser, and the unit prices assigned to the several classes, are subject to ap-

proval by the district director upon examination of the taxpayer's return.

(f) A taxpayer who elects to use the "unit-livestock-price method" must apply it to all livestock raised, whether for sale or for draft, breeding, or dairy purposes. Once established, the unit prices and classifications selected by the taxpayer must be consistently applied in all subsequent taxable years in the valuation of livestock inventories. No changes in the classification of animals or unit prices will be made without the approval of the Commissioner.

* * * * *